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UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re Rome Finance Co., Inc, Debtor.	Case No. 08-45902 J Chapter 11 Date: January 29, 2009 Time: 2:30 p.m. Place: U.S. Bankruptcy Court 1300 Clay Street, 2d floor Oakland, CA 94612

Reply To Debtor's And Creditors Committee Opposition To Acting U.S. Trustee's Motion For Appointment of Trustee

The Debtor and the Official Committee of Unsecured Creditors ("Creditors Committee") oppose the Acting U.S. Trustee's motion for appointment of a trustee on a number of grounds. Essentially, without denying any of the facts relied on, the opposition claims the U.S. Trustee has not shown sufficient evidence of cause for appointment of a trustee. The Acting U.S. Trustee replies that the Debtor's conduct in the Tennessee litigation and with the California Department of Corporations, its admitted diversion of business to parallel-non-debtor corporations, its admitted diversion of profits to Mr. Collins' IRA, and its admitted inability to explain the missing $1.2 million or even to file monthly operating reports, are sufficient evidence of cause for appointment of a trustee.

The Creditors Committee also objects to the Declaration of Matthew R. Kretzer in support of the Acting U.S. Trustee's motion, on the grounds that the statements within it are largely hearsay and are not the best evidence of what was said at the 341 meeting. The Acting

U.S. Trustee replies that none of the essential facts, i.e. the terminating sanctions for discovery abuse, the lack of licensing, the diverting of profits to parallel corporations and Mr. Collins IRA, or the fact of a missing $1.2 million are disputed by the Debtor. The Debtor only contests the subjective intent of its management. Thus, there is enough uncontested evidence to support the motion. In addition, all of the statements made by the Debtor's representative at the meeting of creditors are within the exception to the hearsay rule for statements against interest. If the Debtor or the Creditors' Committee seriously contests any of the important facts, an evidentiary hearing may be required. Any of their objections can be made at that hearing, should the Court deem such a hearing necessary.

1. **The Debtor's Intention To Appeal The Tennessee Judgment Does Not Alter The Fact That The Debtor's Principals Either Mismanaged That Case Or Had No Defense Other Than Delay and Obfuscation.**

The Debtor does not deny that terminating sanctions were imposed on it as a result of its tactics of delay, obfuscation and misrepresentation in the Tennessee case, nor that the judgment will be in excess of $10 million. It also does not deny that the Tennessee litigation may be a preview of consumer protection litigation to occur in California and other states. It merely states that it plans to appeal the Tennessee decision and that Mr. Wilson feels it has a great probability of success. *Debtor's Opposition To Acting United States Trustee's Motion To Appoint a Chapter 11 Trustee* ("*Debtor's Opposition*") page 9, line 24. The Debtor certainly has a right to appeal the Tennessee Court's judgment. However, the intent to appeal does not obviate the Tennessee Court's findings, or entry of a $10 million judgment.

2. **The Debtor's and the Creditors Committee's Argument Re California Finance Company Law Is Further Evidence of the Debtor's Tactics of Delay and Obfuscation.**

The Debtor admits that it was told, two years ago, that it needed to be licensed under the California Finance Lender Law. *Debtor's Opposition*, page 10, line 7. However, it claims that a subsequently received letter from the California Department of Corporations lead the Debtor to believe the license was not needed. The letter, which is attached as Exhibit A to the *Wilson Declaration,* in support of the *Debtor's Opposition* simply asks for more information to allow The Department to process the Debtor's application for a California Finance Lender License.

The fourth item says: "Please state whether you are providing loans or you are financing installment sales contracts." The answer to that is arguably in dispute. (At least the Debtor is relying on such an argument to excuse it from compliance. This argument seems to be negated by an example of the loans attached as Exhibit A to the *Smith Declaration* in support of the *Creditor Committee's Opposition*. The document is titled: "Confidential Credit Application And Credit Agreement." It is written on the Debtor's form with the Debtor's name, address and telephone number. It specifically states on second page, third paragraph: "Applicant(s) understand that they can seek financing anywhere, and they elect to apply to Rome." There can be little real doubt that the Debtor is a finance lender.) Mr. Wilson states, however:

> I interpreted the response to item # 4 of the letter to mean that Debtor was not required to obtain a license, and after consulting with counsel, I did not proceed with the application process. *Wilson Declaration*, page 9 lines 10 - 13.

Mr. Wilson does not attach any correspondence with an attorney. However, the *Smith Declaration*, attaches an opinion letter as Exhibit B. There are two interesting points about that opinion letter. First, it obviously is not based on the actual facts. The attorney's conclusion is based on his understanding of the Debtor's business, contained in the first section:

> As we understand it, you purchase accounts receivable (via a broker) held by various retail consumer goods merchants nation-wide, at a negotiated discount [aka "retail Interchange Fee"] and then, as assignee, collect the amounts due under such accounts by the consumer-borrower. Exhibit B to *Smith Declaration*.

The attorney has not been told that the accounts the Debtor purportedly buys are in fact accounts it originated. The attorney has not been told that, in fact, the Debtor has set up a circuitous arrangement to try to avoid regulators. This is an obvious scheme to avoid California finance lender law. Having already been told that they needed a license, it is disingenuous for the Debtor to claim that it took this question and the explanatory paragraph below it as some sort of exemption from the licensing requirement.

This disingenuousness is highlighted by inspection of the dates of these letters. The information request letter from the California Department of Corporations is dated June 19, 2007. The opinion letter from the attorney is dated July 30, 2008. It is obvious the opinion letter was sought to justify a decision to drop the application process that had been made a year earlier.

Reliance on this request for more information as an excuse to drop the entire application is more evidence of Debtor's intent to delay and obfuscate rather than comply with the laws of the states in which it does business. Its insistence on this obfuscation at this point is more evidence of the need for an independent trustee.

3. Debtor's Failure To Investigate The Requirements of Its Issuing Of Promissory Notes Is Further Evidence of Negligent Management.

The Debtor provides no denial and no explanation of its failure to qualify its notes with the California Commissioner of Corporations. It merely states that it is not issuing new notes and will not until it receives Committee or Court approval. *Debtor's Opposition*, page 10 line 23. It also states that the Creditors Committee is hiring counsel to look into the securities law problem. *Debtor's Opposition*, page 10, line 25 - page 11, line 5. The Debtor is arguably correct that the damage of its possible violation of the securities law is already done; however this violation is also evidence of the negligence of the Debtor's management. The Debtor has been financed by promissory notes to the public since before 1991. It is difficult to believe that no one in Debtor's management ever questioned the requirements of securities law.

4. The Fact That Debtor Is Now Reviewing the Laws of the States Where it Originates Receivables Begs the Question: "Why Only Now?"

The Debtor's opposition states that the Debtor did not believe it was required to be licensed as a financial lender in any of the states in which it operated because of its purported bulk purchases of blocks of accounts receivables, and that it is now reviewing the licensing requirements of the various states. *Debtor's Opposition*, page 11, line 12 - 17. It also states that the Debtors' key personnel have over 100 years of cumulative experience, including Mr. Wilson who has been with the Debtor since 1977. *Debtor's Opposition*, page 5, lines 18 - 24. Given his years of experience, his years with the Debtor, and the prodding of Tennessee and California, the Debtor's management's failure to undertake a review of the licensing requirements of the states in which it does business until now, must be attributed to either incompetence or gross mismanagement.

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5. Debtor's Management Has Already Siphoned Assets and Diverted Profits From the Debtor To Rome LLC and RCC.

The Debtor does not deny that it formed the parallel corporations shortly after Tennessee filed suit, that it in fact operates those corporations, nor that business has been allocated to the parallel corporations since then. It states that it formed the parallel Rome LLC so that it could eventually issue audited financial statements, and that it gave its collection business to the non-debtor RCC to enable it to take losses on bad accounts for tax purposes. It concludes that it is exploring with the Creditor Committee whether these non-debtor entities might be consolidated. *Debtor's Opposition*, page 12, lines 1-19. These reasons are supported only by the declaration of Mr. Wilson, and the Court will determine the credibility of these justifications. Nevertheless, the Court should note that the Internal Revenue Code has provisions for deductions of bad debts that do not require the sale of those debts. *See* 26 U.S.C. § 166.

6. The Debtor Has Already Diverted Profits To Mr. Collins' IRA.

The Debtor's Opposition does not deny that the Debtor operates a parallel business for Mr. Collins' IRA, that Mr. Collins' IRA does not share in the Debtor's overhead expense, and that Mr. Collins is a major shareholder of the parallel Rome LLC and RCC, which suggests that profits have been and are being diverted to Mr. Collins. The explanation provided is that it is recompense for the amounts Mr. Collins voluntarily forfeited which he was entitled to under the prior chapter 11 plan of reorganization. Nevertheless, no written or oral agreements are proffered as evidence. It hardly seems possible that such major settlements are not formalized in some sort of agreement. This arrangement, is more evidence of the need for an independent trustee.

7. The Debtor Has Not Satisfactorily Explained The $1.2 Million Discrepancy In TheBank Accounts.

The Debtor's *Schedule B* indicates that at the inception of this case its personal property included bank accounts with deposits totaling $1,006,874. The Debtor's *Statement of Financial Affairs* (item 14) states that the Debtor holds $1,214,580 in cash for others. At the meeting of creditors, held on November 17, 2008, the U.S. Trustee's counsel asked Mr. Wilson where this $1.2 million of cash being held for others was being held. Mr. Wilson replied that it was in the Debtor's bank accounts and was included in the bank accounts listed in Schedule B. The U.S.

Trustee's counsel noted the amounts being held for others actually exceeded the total amount of cash in the accounts. (If the amounts were equal, it would mean the debtor had no cash in bank accounts other than the cash it was holding for others; thus, this is a $1.2 million issue, not a $200,000 issue.) Debtor and its counsel stated they would investigate the discrepancy. This issue was brought up to the Debtor again in the fact section of the *Memorandum of Points and Authorities in Support of Acting U.S. Trustee's Motion For Appointment of Trustee* at page 4, lines 17 through 24.

To date, the U.S. Trustee has received no explanation of this discrepancy. The only mention of this discrepancy is the footnote at page 12 to *Debtor's Opposition*. That footnote does not explain the discrepancy, but does state that the Debtor intends to amend its schedules to resolve the discrepancy.

8. The Debtor's First Three Monthly Operating Reports Are Delinquent.

The Debtor's Monthly Operating Reports for October, November, and December of 2008 are now delinquent. Neither the U.S. Trustee nor the Creditors Committee can possibly review the Debtor's operations without those reports. This is especially serious in view of the $1.2 million discrepancy.

9. An Independent Trustee Is Needed to Balance the Interests of the Debtor's Insiders and the Noteholders With The Interests Of The Unlisted Consumer Creditors.

The Debtor makes much of the fact that it is supported by the Creditors Committee. This is true, but not reassuring. The Creditors Committee is made up entirely of noteholders, *i.e.*, investors in the Debtor. With the Tennessee judgment, the California investigation, and potential actions by other states, it is clear that there is another body of unidentified-potential claims from persons who probably are not aware of the bankruptcy filing. It is not in the Debtor's nor the noteholders interest to make these potential claimants aware. Indeed, all the evidence indicate consumer and State awareness could seriously complicate the Debtor's business model as well as dilute the noteholders' recovery.

10. The Uncontradicted Evidence Relied Upon In The U.S. Trustee's Original Motion Is Clear and Convincing Enough To Justify Appointment of A Trustee.

Neither the Debtor nor the Creditors Committee deny the Tennessee Court's findings of

discovery abuse rising to a level justifying terminating sanctions. Regardless of Mr. Wilson's declaration of confidence in the appeal, the trial court's findings evidence that Mr. Wilson mismanaged at least the litigation and probably the company. Neither the Debtor nor the Creditors Committee deny that shortly after Tennessee brought suit, the Debtor's principals formed two new corporations and began diverting the Debtor's business to those corporations. These actions evidence cause, in spite of Mr. Wilson's declaration regarding the audit and tax reasons for starting those companies. Neither the Debtor nor the Creditors Committee denies that the Debtor is diverting profits to Mr. Collins. This diversion evidences the need for a trustee even though the Debtor argues that Mr. Collins deserves all or part of those profits. The mere informality of the arrangements whereby profits are divvied out to various parties cries out for a trustee. Finally, to date we have no indication of the location of the $1.2 million the Debtor is holding for others. This evidences of Mr. Wilson's lack of control over the arrangements between the Debtor and the various entities for whom the Debtor is running parallel businesses.

11. <u>A Trustee Is Preferable to An Examiner For Practical Reasons</u>.

The Duties of an examiner and a trustee largely overlap. They are both charged to investigate the Debtor and file a statement of the findings of their investigation. 11 U.S.C. § 1106(a) &(b). A trustee's primary additional duty is to be accountable for the estate's property and actually make business decisions for the estate.

If an examiner is appointed and concludes that a trustee is needed, the examiner can report as much to the Court and the Court can order the appointment of a trustee. However, the examiner cannot be appointed trustee. 11 U.S.C. § 321(b). This creates very large practical problems to appointment of an examiner in any case in which it might be necessary to later appoint a trustee. If the examiner concludes that a trustee is needed, there will first be another hearing on the need for a trustee. Then the U.S. Trustee will have to find a qualified person and appoint that person. Finally, that person will have to start from scratch to learn the facts of the case and to take control.

On the other hand, if a trustee is appointed *ab initio*, and after its investigation the trustee concludes that the services of a trustee are not required, the trustee can report as much and the

Court can discharge the trustee and put the Debtor back in possession.

The Debtor also objects that a trustee will not have the necessary knowledge and experience to manage the Debtor's business as well as Debtor's current management team. This will be an issue left largely to the business judgment of the trustee. However, there is no requirement that a trustee remove current management. The U.S. Trustee would expect the appointed trustee to immediately institute controls to make sure that the Debtor's assets are safeguarded and to be very involved in any major business decisions. However, if the trustee chooses to leave current management and key employees in place, at least pending its investigations, that will be within the trustee's business judgment. In this case, it may very well be that the trustee institutes controls over the assets, leaves Mr. Wilson and other employees in charge of day to day operations, and concentrates his/her efforts on determining what approach to take to resolve the licensing and related legal problems.

It is precisely these issues (how to bring the Debtor into compliance with securities and consumer lending law, rather than merely hiding from the authorities) that an independent trustee appears to be most needed for. That trustee will be able to make a new start with the state agencies, negotiate settlements that take into account the public interests as well as the noteholders' interests and pursue claims against insiders and closely related individuals if warranted.

Dated: January 22, 2008

Respectfully submitted,

Sara L. Kistler,
Acting United States Trustee

By: /s/ Matthew R. Kretzer
Matthew R. Kretzer,
Attorney for the Acting U.S. Trustee